VZCZCXRO0542
PP RUEHLMC RUEHVK
DE RUEHUM #0660/01 2480251
ZNR UUUUU ZZH
P 050251Z SEP 06
FM AMEMBASSY ULAANBAATAR
TO RUEHC/SECSTATE WASHDC PRIORITY 0312
INFO RUEHUL/AMEMBASSY SEOUL 2435
RUEHBJ/AMEMBASSY BEIJING 5214
RUEHKO/AMEMBASSY TOKYO 2222
RUEHML/AMEMBASSY MANILA 1231
RUEHLO/AMEMBASSY LONDON 0047
RUEHMO/AMEMBASSY MOSCOW 1583
RUEHSH/AMCONSUL SHENYANG 0224
RUEHVK/AMCONSUL VLADIVOSTOK 0054
RUEATRS/DEPT OF TREASURY WASHDC
RUCPODC/USDOC WASHDC 1091
RUEHLMC/MILLENNIUM CHALLENGE CORP WASHINGTON DC 0350
RUEKJCS/SECDEF WASHDC

UNCLAS SECTION 01 OF 03 ULAANBAATAR 000660

SIPDIS

SIPDIS

STATE PASS USTR, PEACE CORPS, OPIC, AND EXIMBANK
STATE FOR EAP/CM, EB/TPP, OES/IHA
USAID FOR ANE CALISTA DOWNEY
TREASURY PLEASE PASS USEDS TO IMF AND WORLD BANK
LONDON AND MANILA FOR USEDS TO EBRD AND ADB

E.O. 12958: N/A
TAGS: ECON PREL EAID EMIN SOCI MG
SUBJECT: Fiscal Snapshot: High Mining Revenues a Boon and a Danger

Ref: Ulaanbaatar 576

¶1. SUMMARY: Buoyed by sharp GDP growth in the last few years, Mongolia's government finds itself in a time of relative plenty. However, these large revenue increases have been driven by high international commodity prices for gold and copper. When the good times end for copper and gold, Mongolia may be poorly positioned to cope. Because government expenditures have soared to pay for recent sharp increases in commitments to fund social welfare programs, Mongolia's politicians will be hard pressed to rein in spending. Moreover, recent tax reforms look to sharply cut revenues, at least in the short term, provoking concern about the fiscal situation among the IMF and donors. It is hoped Parliament and Cabinet will work together during the Fall Session to balance anticipated revenues and expenditures. END SUMMARY.

A Word About the Charts and Tables

¶2. This cable is an adapted form of a report by a Treasury economist who has been on TDY to the embassy the last two months. The original report made extensive and helpful use of charts and tables. We have loaded these charts and tables into Yahoo! Photos. A window with all of the charts and tables can be opened by clicking on the link below (readers may need to paste the link into their web browsers).

http://new.photos.yahoo.com/album?c=freemanpj &aid=57
6460762311138245&pid=&wtok=3OE6QM5uMBMgxODw13 nB0Q--
&ts=1156892844&.src=ph#page1

Economic Growth Up Sharply

¶3. Buoyed by the lagged returns to market liberalization, as well as unusually favorable external conditions, Mongolia is experiencing a strong episode of economic growth. Growth of real gross domestic product (GDP) reached 5.6% in 2003 (its highest level since 1995) then shot upwards to 10.7% in 2004, a year marked by a large expansion in mining as well as the rebuilding of livestock herds, before returning to 6.2% in 2005. The International Monetary Fund (IMF) forecasts real GDP growth of 6.5% in 2006, supported in large

part by continued buoyancy in international commodity markets.

Chart 1 (GDP, Total Revenues, Tax Revenues, and Total Expenditures)

Revenues Side: Up High and on Shaky Footing

¶4. Large growth in government revenues has accompanied the recent GDP growth spurt, with central government revenues (including non-tax revenues and net transfers) expected to have grown by 107% nominally; and domestically-financed tax revenues expected to have grown by 136% nominally between 2001 and 2006.

¶5. Mining Sector's Impact on Growth: The mining sector plays a large and growing role in Mongolia's economy, accounting for roughly one-fifth of GDP in 2005. High mining sector profits are playing a central role in explaining unusually high GDP growth. The departure from trend in GDP from the mining sector is expected to account for fully 71% of the departure from trend in overall GDP in 2006, up from an already large 47% in 2005.

Chart 2 (GDP, Mining GIO, Mining GDP):

Table 1 (Comparing GDP and mining sector GDP trends; billions of tugrik):

¶6. External conditions in international commodity markets explain the recent upsurge in mining sector activity, particularly from 2003-2006. Over this period, a 197% increase in the price of copper and a 57% increase in the price of gold are expected to be associated with a 264% increase in GDP from the mining sector.

Chart 3 (Mining GDP and price of copper)

Chart 4 (Mining GDP and price of gold)

¶7. Mining Sector's Impact on Revenues: The ratio of tax revenues from the mining sector to total tax revenues has roughly tracked the ratio of GDP from the mining sector to total GDP. (Note: We only have access to official statistics on government revenues from the mining sector for the period 2002-2005.) Between 2001 and 2005, total tax revenues grew roughly tugrik-for-tugrik with GDP from the mining sector - total growth of tax revenues (roughly 360b Tg) was very close to total growth of mining sector GDP (about 330b Tg). The contribution of growth in GDP from the mining sector to growth in overall GDP nearly doubled from 17% in 2001 to 32% in 2005, while the ratio of total tax revenues to GDP stayed roughly constant at 29-30% over 2001-2005.

Table 2 (Mining sector taxes)

¶8. The overall impact of mining sector activity on tax revenues is likely to be even larger than the mining sector's actual tax payments. In a developing country such as Mongolia, heavily dependent on mining, a significant increase in mining activity typically results in a significant increase in exports, as the majority of minerals are sold on international markets. (Note: However, it is important to note that most of Mongolia's commercially exploitable minerals and metals assets have not come on line. Mongolia remains a small economy, which allows the limited gold and copper mining currently occurring to have exaggerated impacts on the year-on-year economic growth.) Because the resulting positive income shock is denominated in foreign currency, it leads to a larger increase in the consumption of imports than income shocks affecting other components of aggregate demand, and this generates a secondary impact on tax revenues via import duties. In Mongolia's case, imports are on track to rise by approximately 80% in nominal dollar terms between 2003 and 2006. (Note: A 2004 World Bank report, Mongolia's Mining Sector Sources of Growth, provides a more thorough discussion of this and other secondary fiscal transmission mechanisms linking mining sector activity to government revenues.)

¶9. Mongolia's exposure to external shocks, notably the eventual downturns in minerals prices, may be even more significant than most observers perceive it to be. Over 2003-2006, a 197% increase in the price of gold and a 57% increase in the price of copper are expected be associated with an 84% increase in tax revenues. Mongolia's Parliament recently passed a series of major tax reforms that threaten to sharply cut revenues, at least in the short term; and further widen Mongolia's exposure to downturns in commodity markets (reftel). However, reliable estimates of the short- or medium-term impact of the tax reforms are not publicly available at this time. As the Value-added Tax, Corporate Income Tax and Personal Income Tax laws do not take effect until January 2007, time remains for thorough analyses of the projected fiscal impact of the tax reform. In addition, Parliament passed a Windfall Profits Tax law in Spring Session. No companies have pulled out of Mongolia but, if the new tax and other concerns led to a decrease in mining activity in Mongolia, budget revenues from the mining sector would be reduced regardless of the world minerals price trends. Of course, Mongolia's domestic economy is also subject to climate-related shocks, including black and white "dzuds" (too little rain/snow or too much, respectively, causing significant herd reductions affecting the wealth and well-being of Mongolia's herders).

Chart 5 (Tax revenues, and mining sector GIO and GDP)

Chart 6 (Tax revenues and the price of copper)

Chart 7 (Tax revenues and the price of gold)

Expenditures Side: An Urgent Need to Set Priorities
-- ------

¶10. Government expenditures have been increasing at roughly the

same pace as revenues, raising concerns among many observers that Mongolia is failing to take advantage of a passing opportunity to secure its fiscal outlook. Between 2001 and 2006, expenditures are expected to have grown by 100% nominally, roughly tracking the expected 107% growth in revenues over the same period.

¶11. Exacerbating Mongolia's lack of fiscal discipline are political obstacles that will make reversing the recent increases in expenditures difficult, even as positive shocks to revenues recede. There has been a dramatic 162% (130 billion Tg) rise over 2001-2006 in the subsidies and transfers component of current expenditures. Because this increase is closely linked to new government commitments to fund recurrent expenditures, it is cause for special concern. Increases in this category of expenditure may prove to be the most politically difficult type to reverse in the face of falling revenues. The figures in Table 3 and Chart 8 do not fully account for the fiscal repercussions of the recent expansion of the Child Money Program (CMP). Earlier this year, Parliament extended the coverage of the CMP to all households regardless of wealth or income. To add to the fiscal burden, Parliament attached a large new entitlement component to the CMP: a 100,000 Tg lump sum payment to any household welcoming a newborn child.

Chart 8 (Components of government expenditure)

Table 3 (Growth in government expenditures)

Slutz

1